FEDERAL AGRICULTURAL MORTGAGE CORPORATION

Farmer Mac

Joint Statement of
Fred L. Dailey, Chairman of the Board of Directors
and
Henry D. Edelman, President and Chief Executive Officer
before the
Committee on Agriculture
United States House of Representatives

Mr. Chairman, distinguished members of the Committee, our names are Fred Dailey and Henry Edelman; we are, respectively, the Chairman of the Board and the President and CEO of "Farmer Mac," the Federal Agricultural Mortgage Corporation. We appreciate the opportunity you have given Farmer Mac to appear before you today to review the business and corporate activities and financial products of Farmer Mac, particularly as reflected in the October 2003 Government Accounting Office report on Farmer Mac (GAO-04-116).

It has been some time since Farmer Mac last testified before this Committee, and we are pleased to be here today to update you on the forward strides this Corporation has taken in the accomplishment of its mission in a safe and sound manner since Congress expanded its authorities in the Farm Credit Reform Act of 1996.

OVERVIEW

Farmer Mac is accomplishing its Congressional mission of increasing the availability of long-term mortgage credit to farmers and ranchers at stable interest rates by providing greater liquidity and lending capacity to agricultural lenders through a secondary marketing arrangement for qualified mortgages. Since the 1996 revision to its charter, Farmer Mac's $10.7 billion of credit enhancements and purchases have covered more than 33,500 loans that have helped farmers, ranchers and rural homeowners throughout all 50 states. On average, interest rates offered by lenders through the Farmer Mac I program are almost a full percentage point lower than rates on comparable loans, as reported to U.S. Federal Reserve Banks by member banks in agricultural lending states. Through its Farmer Mac II program, Farmer Mac is reaching out to help small and family farmers who would not otherwise be able to obtain financing, and to help finance development of businesses and infrastructure in the Nation's rural communities.

Farmer Mac is operating safely and soundly, consistent with its enabling legislation and in full compliance with current corporate governance standards. Since the inception of its business, Farmer Mac has been required to comply with the rules and regulations of both the Farm

Credit Administration (FCA) and the U.S. Securities and Exchange Commission (SEC). Farmer Mac has been a reporting company for Securities Exchange Act purposes since its initial public offering of stock in 1988, and publicly offered Farmer Mac-guaranteed agricultural mortgage-backed securities (AMBS) have always been required to be registered with the SEC. Farmer Mac files quarterly call reports with the FCA, as well as periodic financial statements in quarterly reports on Form 10-Q and annual reports on Form 10-K with the SEC. The United States Treasury backstop line of credit that supports Farmer Mac's mission-related activities is limited to support of Farmer Mac's guarantees of AMBS and does not extend to the Corporation's debt.

By conventional measures of financial management, Farmer Mac administers its risks conservatively:

- As of March 31, 2004, Farmer Mac's regulatory capital of $245.7 million was almost six times the level required by the Congressionally mandated risk-based capital stress test, and its regulatory core capital was one and two-thirds times the required statutory minimum capital level.
- As of March 31, 2004, Farmer Mac's 90-day delinquencies have trended down to 1.17 percent of the principal balance of all post-1996 Act Farmer Mac I program loans, slightly lower than the average experience of agricultural mortgage lenders for 2003, as reported by the USDA.
- Farmer Mac's reserve for losses meets the accounting requirement under U.S. Generally Accepted Accounting Principles (GAAP) of a provision for "probable and reasonably estimable losses."
- The Corporation's assets and liabilities were closely matched, with a low sensitivity to shifts in interest rates.

Farmer Mac has maintained effective internal controls and conservative risk management, while always working to improve and enhance its risk management practices and tools. Accordingly, as will be explained in detail later in this testimony, the Corporation has generally adopted the recommendations contained in the GAO Report.

While Farmer Mac is similar to other secondary market GSEs, many qualifications upon its ability to do business distinguish Farmer Mac from them. Unlike Fannie Mae and Freddie Mac, public offerings of Farmer Mac guaranteed securities must be registered with the Securities and Exchange Commission; every loan brought into the Farmer Mac program must meet various statutorily mandated credit underwriting and collateral appraisal requirements; and Farmer Mac must comply with numerous other requirements that have distinguished its operating structure from those of the other GSEs.

In further distinction to other secondary market GSEs and most other private sector corporations, Farmer Mac has a Board of Directors composed entirely of outside directors; no member of management serves on the Board. Likewise, the Chairman of the Farmer Mac Board is not the Chief Executive Officer of the Corporation; its President serves in that latter capacity. The Corporation's board and committee membership meet the independence requirements of the SEC rules and NYSE Listing Requirements.

DISCUSSION

Background

The need for Farmer Mac is best explained in the context of the circumstances that gave rise to the creation of this secondary market. In 1987, the U.S. agricultural lending community had just gone through its most serious financial credit crisis since the Great Depression of the 1930's. This prompted concern in Congress that farmers, ranchers and rural homeowners might someday be without stable sources of long-term credit. At the end of 1987, in response to those concerns, Congress passed legislation to facilitate the creation of a secondary market for mortgages backed by agricultural real estate and rural housing that meet rigorous underwriting standards. In the preamble to Farmer Mac's charter, Congress stated its purposes in creating the new secondary market:

- to increase the availability of long-term credit at stable interest rates;
- to provide greater liquidity and lending capacity to lenders who extend credit to farmers and ranchers; and
- to provide for new long-term lending to agriculture with new sources of funding provided through the capital markets, including at fixed rates of interest.

Farmer Mac thus became one of a small group of Congressionally chartered institutions owned by private-sector investors but charged with carrying out specific public policy objectives, subject to Congressional oversight and federal agency regulation and contingently backed by the federal government. Farmer Mac was capitalized initially through the sale of $21 million of common stock, primarily to commercial banks, insurance companies and institutions of the Farm Credit System. <u>No</u> federal funds were invested in Farmer Mac and <u>no</u> federal funds have ever been provided to Farmer Mac to support the Corporation's operations. In fact, Farmer Mac has paid increasingly-sizable annual assessments to the FCA to cover the entire cost to the government of regulating and supervising the Corporation for safety and soundness, an assessment currently equal to one-third of Farmer Mac's total personnel costs.

To relieve structural impediments that had limited Farmer Mac's ability to function efficiently, Congress passed the Farm Credit System Reform Act of 1996 (the 1996 Act), which significantly revised Farmer Mac's statutory authority and significantly improved Farmer Mac's ability to serve rural America. Among other things, the 1996 Act allowed Farmer Mac to: (1) purchase agricultural mortgage loans directly from lenders, "pool" the loans, and create securities that are backed by these pools, for retention or sale; and (2) eliminate the mandatory requirement for loan originators and poolers to retain ten percent, first-loss subordinated interests in each securitized loan pool.

Accomplishments in Fulfillment of Congressional Mission Under the Revised Charter

Since the 1996 revision to Farmer Mac's charter, the Corporation has maintained a ready and consistent daily offer to provide agricultural lenders with a variety of credit enhancements based on capital markets rates and terms. Through those activities, Farmer Mac has provided credit enhancements on agricultural mortgages for farmers, ranchers and rural homeowners throughout America aggregating $9.2 billion through its Farmer Mac I program and an additional $1.5 billion through its Farmer Mac II program. This market presence, in turn, has created new liquidity and lending capacity for participating lenders. As of March 31, 2004, Farmer Mac's total guarantees and standby commitments outstanding were $5.7 billion, resulting in at least $5.0 billion of new lending capacity for agricultural lenders. As of that the same date, Farmer Mac's outstanding purchases of agricultural mortgages stood at $3.3 billion, reflecting an increase in agricultural lenders' liquidity of a like amount.

Through the sale of AMBS or the issuance of its debt, Farmer Mac has used the capital markets as a funding source and as the basis for the interest rates and terms in its loan purchases, guarantees and commitments. Those funding sources afford Farmer Mac the ability to further its mission of providing a secondary market for agricultural mortgage loans.

Farmer Mac's programs have influenced lenders to offer more attractive loan rates and terms when they use Farmer Mac I, as reflected in comparisons of interest rates offered by lenders through the Farmer Mac I program to rates on comparable loans, as reported to U.S. Federal Reserve Banks by member banks in agricultural lending states. It is further evidenced by analyses of rates and spreads in Farmer Mac II loans compared to rates and spreads on U.S. Department of Agriculture (USDA)-guaranteed loans made before the advent of Farmer Mac II. Farmer Mac's programs have also had a positive influence on agricultural mortgage lending through the standardization of agricultural mortgage loan terms offered by lenders across the country, which has contributed to prospective liquidity for the lenders, whether they currently use Farmer Mac or not.

Farmer Mac's Programs

Farmer Mac loan programs are divided into two main groups referred to as Farmer Mac I and Farmer Mac II. Farmer Mac I consists of agricultural and rural housing mortgage loans that do not contain federally provided primary mortgage insurance. For loans underlying pre-1996 Act Farmer

Mac I AMBS, ten percent first-loss subordinated interests mitigate Farmer Mac's credit risk exposure. Before Farmer Mac incurs a credit loss on those AMBS, losses are first absorbed by the poolers' or originators' subordinated interest. As of March 31, 2004, Farmer Mac had not experienced any credit losses related to the pre-1996 Act Farmer Mac I AMBS, and the first-loss subordinated interests are expected to exceed the estimated credit losses on those loans. Current risks in Farmer Mac's loan and guarantee portfolio, such as those discussed later in this testimony, are generated primarily by post-1996 guaranteed securities and loans. Farmer Mac receives an annual guarantee fee from the third party or trust involved based on the outstanding balance of the Farmer Mac I post-1996 AMBS.

With particular regard to the availability of long-term credit, Farmer Mac has, since 1996, operated a "cash window" program in which it offers daily rate locks on long-term mortgage loans, including fixed rates. Through the cash window, Farmer Mac purchases mortgages directly from lenders for cash and purchases mortgage-backed bonds from agricultural lenders. Periodically, Farmer Mac transfers its purchased loans into trusts that it uses as vehicles for the securitization of those loans. Securitization is the transfer of assets (in this case, loans) to a third party or trust. In turn, the third party or trust issues certificates to investors. Farmer Mac refers to such certificates as "guaranteed securities" or as agricultural mortgage-backed securities (AMBS). The cash flow from the transferred loans supports repayment of the AMBS. Farmer Mac guarantees timely payments to investors holding the certificates, regardless of whether the trust has actually received such scheduled loan payments.

Farmer Mac's long-term standby purchase commitments (standby agreements), introduced in 1999, represent a commitment by Farmer Mac to purchase eligible loans from financial institutions at an undetermined future date if a specific event occurs. The specific events or circumstances that would require Farmer Mac to purchase loans under a standby agreement include when: (1) an institution determines to sell at mark-to-market prices some or all of the loans that are not then more than 120 days delinquent under the agreement to Farmer Mac; or (2) a borrower fails to make installment payments for 120 days on a loan covered by a standby agreement. Upon entering into a standby agreement with Farmer Mac, financial institutions effectively transfer the credit risk on the loans covered by a standby agreement to Farmer Mac over the life of the agreement. Consequently, these institutions' regulatory capital requirements and loss reserve requirements would then be reduced. To date, Farm Credit System (FCS) institutions have been the only participants in standby agreements, though they are available to all agricultural lenders. In exchange for Farmer Mac's commitment under the standby agreement, Farmer Mac receives an annual commitment fee from institutions entering into these agreements, based on the outstanding balance of the loans covered by the standby agreement. Any standby agreement party may, at any time, require that Farmer Mac issue to it, in exchange for the loans covered by the standby, a guaranteed security backed by those loans.

Farmer Mac II is Farmer Mac's program for acquisition of USDA-guaranteed portions of farm ownership, farm operating, business and industry and community facilities loans to enable lenders to fund more of those loans at lower rates. Those USDA-guaranteed loans are backed by the full faith and credit of the United States. Similar to the pre-1996 Act securities, Farmer Mac has experienced no credit losses in the Farmer Mac II program and does not expect to incur any such losses in the future.

Farmer Mac is the single largest purchaser of USDA-guaranteed loans. Since the inception of the Farmer Mac II program in 1991, Farmer Mac has purchased approximately $1.5 billion in guaranteed portions, representing over 6,500 loans to small and family farmers and rural businesses and communities, of which $723 million were outstanding as of March 31, 2004 (reflecting an annual growth rate of 13%). As of March 31, 2004, 660 sellers from 45 states had participated in the Farmer Mac II program. The core group of active sellers (defined as sellers who have sold loans into the Farmer Mac II program since January 1, 2002) total 217 USDA-guaranteed loan originators (selling 1,718 loans totaling $491 million), most of which are small to mid-size community banks; the group also includes mortgage companies and credit unions, as well as FCS institutions.

Farmer Mac II program volume in 2003 was a record-setting $271 million, compared to $173 million in the prior year. This growth represented a $98 million or 56% increase, in which:

- 78% (or $210 million) of 2003 Farmer Mac II volume was from the purchase of USDA-guaranteed farmer program loans.
- 22% (or $61 million) of 2003 Farmer Mac II volume was from the purchase of USDA-guaranteed community facility and business and industry loans.

Benefits to Agricultural Borrowers

Rates available on real estate loans purchased in the Farmer Mac I program are typically 85/100ths of a percentage point lower than the average rate on such loans made by commercial banks, as published by the Federal Reserve. According to the United States Department of Agriculture, there is approximately $111 billion of agricultural real estate debt outstanding today, of which we estimate about $45 billion is eligible for Farmer Mac loans. Farmer Mac currently provides credit enhancement and, in many cases, funding for approximately 20,800 loans to borrowers in all 50 states. Today, Farmer Mac's guarantees and commitments outstanding equal $5.7 billion, nearly 13% penetration of the eligible market. On the basis of the current Farmer Mac-eligible market, the current potential savings to agricultural borrowers from Farmer Mac can be estimated between $25 million and $60 million per annum, depending on the extent to which portfolio lenders pass back to borrowers the advantages of past transactions with Farmer Mac in their future lending activities. If half of the eligible market were covered by Farmer Mac guarantees, analogous to the market penetration of other secondary market GSEs, the savings to farmers could be as great as $225 million per year.

In addition to those monetary savings, Farmer Mac is a primary source of fixed-rate mortgage financing that offers the advantage of stable rates that do not fluctuate with short-term interest rates.

This stability is of particular importance to agricultural borrowers when farmers stand to profit from higher commodity prices in an inflationary economy. Affected borrowers with short-term adjustable interest rate loans may give up a significant portion of those profits in higher interest payments. A viable entity such as Farmer Mac can provide stable, long-term fixed rates of interest when rates rise under inflationary pressures, resulting in a consistently available benefit to agriculture.

In its Farmer Mac I program, Farmer Mac is reaching small and family farmers, as reflected by the average loan size of $275,000 in that program, with 75% of the loans under $300,000.

Of the $210 million of USDA-guaranteed farmer program loans purchased in Farmer Mac II in 2003, $177 million were made to borrowers who locked in intermediate- or long-term (5- to 25-year) fixed interest rates. Furthermore, 40% (or $84 million) of that farmer program loan volume was specifically tied to the 5-year reset Farmer Mac II Cost of Funds Index. During 2003, Farmer Mac II allowed lenders to offer borrowers fixed rates of interest on intermediate term loans at historically low levels, less than one point above the prevailing Prime Rate typically used for short-term floating rate loans.

Through its Farmer Mac II program, Farmer Mac works closely with not only the lenders in our selling group, but also with state and county USDA field offices. The Farm Service Agency's farmer program guaranteed loans are available only to small and family farmers and ranchers who cannot obtain direct commercial credit from a local agricultural lender. USDA business and industry loans, which do not have a test for credit, encourage the financing of rural businesses, thereby creating and saving rural jobs as well as improving the economic climate of rural communities. With both of these important USDA programs, Farmer Mac adds significant value by serving as a constant, dependable source of liquidity and interest rate risk management for participating lenders. As previously mentioned, Farmer Mac has assisted in the financing of more than 6,500 USDA guaranteed loans to date, totaling approximately $1.5 billion.

Benefits to Agricultural Lenders

In the preamble to Farmer Mac's statutory charter, it is stated that the Corporation was formed to: increase the availability of long-term credit to farmers and ranchers at stable interest rates; and provide greater liquidity and lending capacity in extending credit to farmers and ranchers through a secondary marketing arrangement for qualified mortgages with new sources of funding provided through the capital markets.

a. Liquidity - Loan purchases by Farmer Mac recharge the lenders' funds available to make additional loans, thereby creating new liquidity. Farmer Mac has always maintained a ready and consistent daily offer to purchase or guarantee loans conforming to Farmer Mac's credit and appraisal standards, based on the Corporation's access to the capital markets. Farmer Mac has purchased $4.5 billion of agricultural loans in Farmer Mac I and Farmer Mac II to date; the balance of loans purchased as of March 31, 2004 was $3.3 billion.

b. Lending Capacity - In addition to its loan purchases, Farmer Mac's guarantees and commitments on securities and agricultural loans held by lenders enable those lenders to make more loans without increasing their equity. The Farmer Mac guarantee or commitment decreases to one-fifth the amount of equity that lenders must maintain to support those loans, giving them five times as much capacity to make loans based on the same equity. Since the 1996 revision to Farmer Mac's charter, Farmer Mac has purchased or provided guarantees and commitments on $10.7 billion of agricultural mortgage loans to farmers, ranchers and rural homeowners throughout America. As of March 31, 2004, the balance of loans purchased, guarantees and commitments outstanding was $5.7 billion.

Farmer Mac's Congressional mission clearly states the legislative intent that it should increase lending capacity, i.e., enable lenders to make more loans without increasing their equity, as we have described. The justification for the resulting higher leverage is the higher quality of the loans which, as required by Farmer Mac's charter, must be first mortgages on agricultural real property that meet appraisal, underwriting and documentation standards established by Farmer Mac's Board of Directors. Federal banking regulators and FCA set uniform regulatory capital levels for primary lenders that encompass not only first mortgage loans (except residential loans), but also a wide spectrum of riskier loans, including second mortgage loans, personal property loans, signature loans, and credit card receivables. Only agricultural first mortgage loans that meet Farmer Mac's standards are eligible for a Farmer Mac guarantee or commitment.

Critics of Farmer Mac have claimed that its secondary market activities undermine capital support of mortgage loans on the books of regulated entities. Those critics use the term "capital arbitrage" to disparage the legitimate process by which Congress enabled lenders to make more agricultural mortgage loans without increasing the regulatory capital they hold to support those mortgages. This is accomplished through the regulatory assignment of a lower capital requirement ("risk weight") to mortgages supported by a Farmer Mac guarantee or commitment. Criticism of that process of increasing the lending capacity of agricultural lenders through the judicious use of Farmer Mac as a secondary market GSE is inconsistent with the intent of Congress expressed in the preamble to Farmer Mac's charter. Nothing else could have been meant by the phrase "provide greater. . . lending capacity" in 12 U.S.C. §2279aa (note)(3)(B). The 20% regulatory risk weight assigned to mortgages and AMBS that are credit enhanced by Farmer Mac is consistent with the intent of Congress that Farmer Mac should, by increasing the lending capacity of agricultural lenders, generate sizable economic benefits for the farmers, ranchers and rural homeowners of this Nation.

Adequacy of Farmer Mac's Capital

Farmer Mac's core capital as of March 31, 2004 totaled $223.7 million and exceeded its statutory minimum capital requirement of $132.2 million by $91.5 million. Farmer Mac is also required to meet the capital standards of the risk-based capital stress test promulgated by FCA (RBC test). The RBC test is a worst-case scenario based on industry loan loss data from the experience of the Farm Credit Bank of Texas in the mid-1980's (FCBT data). The RBC test determines the amount of regulatory capital Farmer Mac would need to maintain a positive capital position during a ten-year stress period of extraordinary credit losses and interest rate volatility. The RBC test then increases the capital requirement by an additional thirty percent to cover operational risks.

As of March 31, 2004, the RBC test generated a capital requirement of $42.0 million. Farmer Mac's regulatory capital of $245.7 million exceeded that capital requirement by $203.7 million.

Credit

As of March 31, 2004, Farmer Mac's 90-day delinquencies were trending downward at $57.4 million, or 1.17 percent of the outstanding portfolio, slightly lower than the average experience of agricultural mortgage lenders for 2003, as reported by the USDA. This also compared favorably to Farmer Mac's 90-day delinquencies of $76.2 million (1.58 percent) a year earlier.

As part of the loss mitigation process, Farmer Mac may acquire the real estate securing its loans. When a property is acquired in the loss mitigation process, Farmer Mac develops a liquidation strategy that results in either an immediate sale or retention pending later sale. Farmer Mac evaluates these and other alternatives based upon the economics of the transactions and the requirements of local law. As of March 31, 2004, Farmer Mac owned $12.3 million of such collateral, compared to $15.5 million as of December 31, 2003 and $8.2 million as of March 31, 2003.

Since its inception, Farmer Mac I has accepted the credit risk on $9.2 billion of agricultural mortgage loans and has incurred an aggregate of just $11.8 million of credit losses, about one-eighth of one percent. Coupled with the recent downward trend in delinquencies, Farmer Mac believes that this history evidences its prudent credit risk management practices. Additionally, Farmer Mac provides an allowance for losses in conformity with GAAP as a reserve to cover "probable and reasonably estimable losses" as required by Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. As of March 31, 2004, that represented a reserve for further losses of $22.2 million.

Interest Rate Risk

Farmer Mac measures its interest rate risk through several tests, including the sensitivity of its Market Value of Equity (MVE) and Net Interest Income (NII) to uniform or "parallel" yield curve shocks. As of March 31, 2004, a parallel increase of 100 basis points across the entire U.S. Treasury yield curve would have increased MVE by 0.5 percent, while a parallel decrease of 100 basis points would have decreased MVE by 0.8 percent. As of March 31, 2004, a parallel increase of 100 basis points would have increased Farmer Mac's NII, a shorter-term measure of interest rate risk, by 2.8 percent, while a parallel decrease of 100 basis points would have decreased NII by 4.3 percent. Farmer Mac's duration gap, another measure of interest rate risk, was only minus 0.5 months as of March 31, 2004.

The goal of Farmer Mac's interest rate risk management is to create and maintain a portfolio that generates stable earnings and value across a variety of interest rate environments. Farmer Mac's primary strategy for managing interest rate risk is to fund asset purchases with liabilities that have similar durations so that they will perform similarly as interest rates change. To achieve this match, Farmer Mac issues discount notes and both callable and non-callable medium-term notes across a spectrum of maturities. Farmer Mac issues callable debt to offset the prepayment risk associated with its mortgage assets. By using a blend of liabilities that includes callable debt, the interest rate sensitivities of the liabilities tend to increase or decrease as interest rates change in a manner similar to changes in the interest rate sensitivities of the assets.

Taking into consideration the prepayment provisions and the default probabilities associated with its mortgage assets, Farmer Mac uses prepayment models to project and value cash flows associated with these assets. Because borrowers' behavior in various interest rate environments may change over time, Farmer Mac periodically evaluates the effectiveness of these models compared to actual prepayment experience and adjusts and refines the models as necessary to improve the precision of subsequent prepayment forecasts. In addition, Farmer Mac consults with independent prepayment experts as part of the model evaluation process. Regular back-testing of existing proxy prepayment models (comparing forecast to actual prepayment experience) has consistently demonstrated the predictive accuracy of existing models for prepayment experience in Farmer Mac's portfolio of program assets, thereby ensuring accurate interest rate risk measurement.

Farmer Mac also uses financial derivatives to alter the duration of its assets and liabilities to better match their durations, thereby further reducing overall interest rate sensitivity. Farmer Mac uses those instruments solely for hedging risk, not for speculative purposes. All of Farmer Mac's financial derivative transactions are conducted through standard, collateralized agreements that limit Farmer Mac's potential credit exposure to any counterparty. As of March 31, 2004, Farmer Mac had no uncollateralized net exposure to any counterparty.

Comments on GAO Report

Farmer Mac has previously received and reviewed the October 16, 2003 General Accounting Office (GAO) Report on Farmer Mac (No. GAO-04-116) titled, *Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission and Corporate Governance Needed*, addressing topics in the June 2002 request letter from the Senate Committee on Agriculture, Nutrition and Forestry to GAO. It was gratifying to note that, after the third examination and review of Farmer Mac by GAO over the course of the past six years, no serious deficiencies in the implementation of Farmer Mac's programs or mission were identified; recommendations were made for enhancing risk management procedures in light of the Corporation's continuing growth; and a number of positive findings were made about the safety and soundness of Farmer Mac's operations and about its progress in establishing the secondary market for agricultural mortgages.

In its previous report on Farmer Mac, dated May 21, 1999, GAO had concluded that "Farmer Mac's future viability depends on its growth potential in the secondary market for agricultural mortgages and the prospects for realizing that potential are unclear. . . . if FCS institutions or other lenders increase participation in Farmer Mac programs, Farmer Mac's financial condition could improve." Working with agricultural lenders throughout the Nation, Farmer Mac's Board and management have resolved favorably the uncertainties raised in that earlier report, reflected in dramatic increases in participation in Farmer Mac's programs. Thus, Farmer Mac is pleased with the most recent Report's recognition of Farmer Mac's progress in the four intervening years, in terms of both its financial strength and the growth of its mission-related activities. At the same time, Farmer Mac shares GAO's view, expressed in the Report, that Farmer Mac should continue to enhance its risk management, because the efficiency of our operations will be a key factor in the accomplishment of our mission and the overall success of Farmer Mac. Farmer Mac has already implemented several enhancements to risk management procedures since the issuance of GAO Report, and is in the process of implementing others, as will be explained later in this testimony.

The Chairman and Ranking Member of the United States Senate Committee on Agriculture, Nutrition, and Forestry, in their letter request of June 26, 2002, sought GAO's assistance "to ensure that Farmer Mac's mission continues to be met in a financially sound manner." As to the six specific topics GAO was asked to address in that letter, the GAO Report:

(1) found no current financial instability at Farmer Mac, noting that: independent accountants issued Farmer Mac a "clean," unqualified audit opinion; an outside forensic accounting firm concurred with Farmer Mac's methodology for estimating loan loss allowance under GAAP; Farmer Mac effectively managed its interest rate risk through asset/liability matching and yield maintenance protection against prepayment risk; and Farmer Mac's controls over credit risks were generally sound, but could be improved in light of recent and expected future growth. Since the date of the GAO Report, Farmer Mac's independent accountants issued Farmer Mac a "clean," unqualified audit opinion on the Corporation's 2003 financial statements.

(2) found no significant shortcomings in corporate governance; acknowledged that Farmer Mac was taking actions to ensure that it complies with recent Sarbanes-Oxley Act and NYSE listing requirements, as they become effective; and noted areas in which Farmer Mac (like other private sector corporations) might have to update its corporate governance, including expanded director training. Since the date of the GAO Report: Farmer Mac's Board adopted a Code of Business Conduct and Ethics; adopted new Board committee charters; participated in director training with outside counsel and the National Association of Corporate Directors; received advice of outside counsel that it is in full compliance with Sarbanes-Oxley requirements currently in effect; nominated a certified public accountant from a firm not associated with the Corporation for election as a director at the 2004 Annual Meeting of Stockholders; revised its committee structure to eliminate its Executive Committee, transferring those responsibilities to the Corporate Governance Committee; and will tomorrow bifurcate its Program Development Committee into separate Credit and Marketing Committees.

(3) found executive compensation was in line with the recommendations of two independent consultants, but recommended that the timing of vesting of stock options be extended, which the Farmer Mac Board has done. Since the date of the GAO Report, the Compensation Committee directed its outside consultant to perform a zero-based analysis of executive compensation and to advise on incentive compensation alternatives to stock options for directors and officers.

(4) found no irregularities in Farmer Mac's investment practices or strategy and that non-mission investments have been reduced as a percentage of mission-related assets.

(5) recommended that Congress reconsider the non-voting status of Farmer Mac Class C common stock.

(6) noted that Farmer Mac has increased its Congressional mission-related activities (loan purchases, guarantees and commitments) since GAO's 1999 report, and recommended that Congress consider establishing more specific criteria for measurement of Farmer Mac's mission accomplishment. Since the date of the GAO Report, the Public Policy Committee has adopted a requirement for regular monitoring of mission accomplishment.

In addition, the Report raised several hypothetical or problematic issues. For simplicity, those issues are paraphrased in italics below, with Farmer Mac's observations following them.

(a) As Farmer Mac's Long-Term Standby Purchase Commitments (LTSPCs) continue to grow, if risks were not closely managed and there were massive defaults on those loans far beyond the worst levels experienced in U.S. agricultural economic history, the Corporation could be required to acquire a high proportion of the outstanding loans covered by LTSPCs, resulting in a possible future funding risk.

This hypothetical relies upon words "if," "and," "far beyond," "could," and "possible" to such a degree as to render its premise too implausible to deserve serious consideration. To hypothesize circumstances in which Farmer Mac would face a "possible future funding risk," the GAO Report had to posit: (1) unchecked mismanagement of risks at Farmer Mac (despite close management, Board, FCA monitoring and securities law disclosure of the components of those risks); (2) loan defaults far beyond the 13.8% default rate peak for all agricultural loans (including non-mortgage loans) within a concentrated geographic region in the Farm Credit System in 1986, the worst period in recorded U.S. agricultural economic history; (3) significant impairment of the value of the collateral behind those loans, for which the weighted average loan-to-value ratio at origination was less than 50%; (4) nearly simultaneous default among a group of thousands of Farmer Mac loans diversified by commodity and geography, and (5) an inability on Farmer Mac's part to issue $2.5 billion of new short-term debt, a small amount relative to its current annual issuance rate of over $100 billion of such instruments. Without discussing Farmer Mac's 90-day delinquency rate on the LTSPCs referenced in the GAO Report at 0.1%, Farmer Mac notes that, while the hypothetical is incredibly remote, the additional funding required would not be inconsistent with Farmer Mac's demonstrated level of access to the capital markets.

(b) *With respect to guaranteed AMBS held by Farmer Mac, the U.S. Treasury has questioned whether it would be required to allow Farmer Mac to draw upon its Treasury line of credit to support those guarantees.*

No issue has been raised as to the availability of Farmer Mac's statutory Treasury line of credit relative to AMBS held by parties other than Farmer Mac and, if Farmer Mac were coming under pressure to fund its guarantee obligations, it would sell to third parties any AMBS it held long before it needed to access the Farmer Mac Treasury line of credit.

Farmer Mac recognizes that there are a number of areas in its business that will continue to evolve and need attention. Independent of, but consistent with the findings and recommendations in the GAO Report, Farmer Mac has taken a number of steps to enhance its risk management practices. With respect to the recommendations for Farmer Mac itemized on pages 57 and 58 of the GAO Report, the Corporation has taken the following actions:

(a) The GAO Report cites the conclusion of a prominent agricultural economic consultant to Farmer Mac's federal regulator, the FCA, that the FCBT data was the "best available" data for the purpose of building a model to estimate Farmer Mac's credit risk, but it nevertheless concludes that it would be better if Farmer Mac were using its own historical data. Since the date of the GAO Report, Farmer Mac has taken great strides toward the development of a model based on its own historical data to estimate the credit risk in its portfolio and ultimately establish loss reserves. Farmer Mac is currently testing that model and expects to migrate to the model by 2005, and will continue to use the FCBT data in a manner consistent with GAAP until that migration is completed. Farmer Mac has enhanced its loan classification system as a critical step in the process of migrating our loss allowance and reserve process to a methodology based on Farmer Mac's loan loss experience rather than the FCBT data. Farmer Mac also uses its loan classification system as the basis for its internally developed capital adequacy model. Farmer Mac measures its capital adequacy against this model, in addition to the statutory minimum capital levels established by Congress and risk-based capital levels established by FCA.

(b) Farmer Mac has continued to gather documentation supporting underwriting decisions based on compensating strengths of loans to be used in supporting future underwriting decisions and considered in the enhancement of Farmer Mac's loan classification system. With respect to loans resulting from those underwriting decisions, the Corporation has enhanced its documentation procedures; its tracking of the subsequent performance of those loans; and conformed its loan loss reserve methodology and procedures.

(c) During 2004, Farmer Mac has marketed and sold on-books AMBS at prices similar to those of comparable GSE securities. The Corporation will continue to market and sell AMBS on a periodic basis in the future.

(d) Farmer Mac has formalized a contingency funding plan. Farmer Mac has formalized the Corporation's long-standing liquidity contingency funding plan, with Board action confirming the new plan, adopted in August 2003. Farmer Mac completed two significant floating rate medium-term note (MTN) issuances totaling $280 million during first quarter 2004 to enhance its balance sheet liquidity and reduce its exposure to discount refunding needs. The Corporation has conducted regular fixed-rate MTN issuances, in lieu of floating-to-fixed interest rate swaps, according to its MTN needs supporting program purchases. During 2003 and 2004 to-date, Farmer Mac issued a total of $749 million of MTNs at rates similar to those of comparable GSE securities. A comprehensive analysis of Farmer Mac liquidity needs is has been performed, based on the *Sound Practices for Managing Liquidity in Banking Organizations* issued by the Basel committee on Banking and Supervision in 2000. Farmer Mac maintained an average of 92 days' liquidity during first quarter 2004. Farmer Mac's Board adopted a new liquidity policy in April 2004, with a 60-day minimum liquidity requirement and a 90-day liquidity target.

(e) Farmer Mac has been consulting with a nationally-recognized prepayment expert to ensure the continued accuracy of its current prepayment model and to develop a proprietary prepayment model based on its own portfolio agricultural mortgage prepayment data. The prepayment models used by Farmer Mac to date have been consistent with models used by other agricultural mortgage lenders. Since no publicly available agricultural mortgage prepayment database exists, Farmer Mac has used several residential prepayment models, adjusted to reflect the differences in the behavior of agricultural and residential mortgage borrowers, with validation by a recognized outside expert on prepayment modeling; and the accuracy of Farmer Mac's model has been confirmed through "back-testing," i.e., verifying model forecasts against actual outcomes. Regular back-testing of adjusted proxy prepayment models has consistently demonstrated the predictive accuracy of those models for prepayment experience in Farmer Mac's portfolio of program assets, thereby ensuring accurate interest rate risk measurement. Since the date of the GAO Report the design of a prototype Farmer Mac agricultural mortgage prepayment model has been completed by the prepayment consultant and is expected to be available for Farmer Mac's use in its interest rate risk management during the latter part of 2004.

(f) Independent of its statutory and regulatory capital requirements, Farmer Mac has developed a capital adequacy model for internal use in its capital planning.

(g) Farmer Mac's Board has extended the vesting period of new grants of stock options on Farmer Mac's Class C non-voting common stock, effective January 2004.

(h) Farmer Mac is working with its corporate governance advisors to assure that the Board nomination process continues to comply with all applicable laws and regulations. Farmer Mac's Board has reviewed, and confirmed by unanimous resolution, that all of its members understand the nomination process and they consider it to be "transparent." Moreover, Farmer Mac and its counsel believe the nomination process is fully and fairly disclosed in its Proxy Statement issued in connection with its 2004 Annual Meeting of Stockholders.

(i) Farmer Mac's Board formalized the Corporation's management succession plan in June 2003, and will do so annually each year at its June meeting. Farmer Mac has initiated a formal training program for its Board of Directors, including consultation and participation with the National Association of Corporate Directors. In fact, in December 2003, in conjunction with the Board's meeting, the members participated in an eight hour training program on Director Professionalism presented by the NACD. The Board intends to participate in at least one "outsider provided" training program each year, generally in conjunction with its December meeting and receives more detailed briefings on specific Farmer Mac-related subjects on a regular basis from the Farm Credit Administration and management. Three examples of management briefings included reviews of: (1) Farmer Mac debt issuance and investment strategy; (2) Farmer Mac interest rate risks and asset and liability management strategy; and (3) Farmer Mac's use of derivatives and the advantages and disadvantages of such instruments.

Farmer Mac has fully considered GAO's recommendations and is continuing to enhance its operations consistent with them. These and other enhancements have further strengthened Farmer Mac as it continues to carry out its mission in a safe and sound manner for the benefit of the Nation's farmers and ranchers.

CONCLUSION

The Board of Directors of Farmer Mac – statutorily mandated to be composed of five appointees of the President of the United States, five representatives of Farm Credit System institutions and five representatives of commercial banks, insurance companies and other financial institutions – works together as an alliance unique in agricultural finance to accomplish Farmer Mac's important Congressional mission. Farmer Mac is receptive and responsive to criticism and recommendations from Congress and GAO as its investigative arm, regulators such as FCA and the SEC, agricultural lenders, capital markets debt and equity investors, and – most important – farmers, ranchers and rural homeowners. Every day, Farmer Mac seeks new ways to satisfy all of those important constituencies in furtherance of its Congressional mission, safe and sound operation, and creation of stockholder value. Farmer Mac welcomes this hearing as an opportunity to explain how we attempt to satisfy each of those interests.

Thank you for the opportunity you have generously provided Farmer Mac to give testimony on this matter of great importance to American agriculture. We would be pleased to answer any questions you may have at this time.

Note on Forward Looking Statements

In addition to historical information, this testimony includes forward-looking statements that reflect management's current expectations for Farmer Mac's future financial results, business prospects and business developments. Management's expectations for Farmer Mac's future necessarily involve a number of assumptions and estimates and the evaluation of risks and uncertainties. Various factors could cause Farmer Mac's actual results or events to differ materially from the expectations as expressed or implied by the forward-looking statements, including uncertainties regarding: (1) the rate and direction of development of the secondary market for agricultural mortgage loans; (2) the possible establishment of additional statutory or regulatory restrictions or constraints on Farmer Mac that could hamper its growth or diminish its profitability; (3) legislative or regulatory developments or interpretations of Farmer Mac's statutory charter that could adversely affect Farmer Mac or the ability or motivation of certain lenders to participate in its programs or the terms of any such participation, or increase the cost of regulation and related corporate activities; (4) possible reaction in the financial markets to events involving government-sponsored enterprises other than Farmer Mac; (5) Farmer Mac's access to the debt markets at favorable rates and terms; (6) the possible effect of the risk-based capital requirement, which could, under certain circumstances, be in excess of the statutory minimum capital requirement; (7) the rate of growth in agricultural mortgage indebtedness; (8) lender interest in Farmer Mac credit products and the Farmer Mac secondary market; (9) borrower preferences for fixed-rate agricultural mortgage indebtedness; (10) competitive pressures in the purchase of agricultural mortgage loans and the sale of agricultural mortgage backed and debt securities; (11) substantial changes in interest rates, agricultural land values, commodity prices, export demand for U.S. agricultural products and the general economy; (12) protracted adverse weather, market or other conditions affecting particular geographic regions or particular commodities related to agricultural mortgage loans backing Farmer Mac I Guaranteed Securities or under LTSPCs; (13) the willingness of investors to invest in agricultural mortgage-backed securities; or (14) the effects on the agricultural economy or the value of agricultural real estate of any changes in federal assistance for agriculture. Other factors are discussed in Farmer Mac's Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 15, 2004, and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2004, as filed with the SEC on May 10, 2004. The forward-looking statements contained in this testimony represent management's expectations as of the date of this testimony. Farmer Mac undertakes no obligation to release publicly the results of revisions to any forward-looking statements included in this testimony to reflect any future events or circumstances, except as otherwise mandated by the SEC. Both of the referenced filings are available on Farmer Mac's website at www.farmermac.com.

Curriculum Vitae of Fred L. Dailey

FRED L. DAILEY
Chairman of the Board

Fred has been a member of the Board of Directors of the Corporation and has served as its Chairman since August 16, 2002. He also serves as chairman of the Corporate Governance Committee and is a member of the Compensation Committee and the Public Policy Committee.

His appointment to the Board was confirmed by the United States Senate on July 29, 2002. Mr. Dailey is the Director of the Ohio Department of Agriculture, in which position he has served since 1991. Prior to that time, he was the executive vice president of the Ohio Beef Council and executive secretary of the Ohio Cattlemen's Association from 1982 to 1991 and served as the Director of the Indiana Division of Agriculture from 1975 to 1981. Mr. Dailey is past President of the National Association of State Departments of Agriculture and has received the FFA Honorary State Farmer degree from both Ohio and Indiana. In 1998, he received the national "Outstanding State Agriculture Executive" award presented by the Biotechnology Industry Organization and was named "Man of the Year" by Progressive Farmer magazine in 1999.

Mr. Dailey resides on a working farm in Ohio where he raises Angus cattle.

Curriculum Vitae of Henry D. Edelman

HENRY D. EDELMAN
President and Chief Executive Officer

Henry joined Farmer Mac in June 1989 as the President and CEO of the newly-formed corporation. During his tenure, Farmer Mac established its operations, obtained an enhanced charter from Congress, and has averaged a 42% growth rate in outstanding guaranteed securities for the last five years.

Before joining Farmer Mac, Henry was First Vice President for Federal Government Finance of PaineWebber Incorporated, beginning in 1986. Among other duties during that period, Henry served as the outside financial advisor for loan asset sales to the Small Business Administration and the U.S. Department of Housing and Urban Development, and was responsible for the firm's investment banking services to federal agencies and government-sponsored enterprises. Previously, he was Director of Financing, Investments and Capital Planning at General Motors Corporation in New York, New York.

Henry is a graduate of Colgate University (BA, MA 1970) and of The Cornell Law School (JD 1973). Henry is a native of New York, is married and has a son and a daughter.